

below the benchmark.⁵⁸ For transport, ILEC special access rates were compared to competitors' prices for inter-city transport services on routes with facilities-based competition.⁵⁹ T-Mobile concluded that "the cost of a 10 mile Verizon special access DS3 circuit in New York is \$1,817.12, or over 100 times more than the \$14.00 per mile price of a circuit of the same length along the New York-Los Angeles route."⁶⁰ Competitors certainly would have entered into such a lucrative market but for the existence of barriers to entry that make it uneconomic for them to enter.⁶¹ T-Mobile further concluded that, even taking into account the economies of scale associated with distance, special access price in every market analyzed ranges from two to six times the expected price if competition existed.⁶² This is consistent with the experience of WilTel and CompTel/ALTS that the prices of competitive access providers often are 30% to 50% below ILEC rates.⁶³

As previously noted, BellSouth admits that its month-to-month prices for DS1 and DS3 special access services have increased and that its tariffed rates have increased.⁶⁴ BellSouth asserts that rates for DS1s held for 24 months or longer have remained constant;⁶⁵ however, even if true, the fact that rates have stayed the same in a declining cost environment is "tantamount to

⁵⁸ *Id.*, at ¶ 10.

⁵⁹ *Id.*, at ¶ 11.

⁶⁰ *Id.*, at ¶ 13.

⁶¹ *Id.*, at ¶ 14.

⁶² *Id.*, at ¶ 18.

⁶³ WilTel Reply Exhibit 1; CompTel/ALTS Comments, WC Docket 05-25, Declaration of Janet S. Fisher., ¶ 9 (concluding that competitors' rates for special access are one-half to one-third of the BOC prices).

⁶⁴ BellSouth Comments, at 14-16.

⁶⁵ *Id.*, at 17

a price increase.”⁶⁶ SBC even admits that its rates are higher in MSAs with pricing flexibility.⁶⁷ While Verizon maintains that its special access prices have declined, the evidence it proffers is not a comparison of actual changes in price, but is an modeling exercise based on “average revenue per voice grade equivalent.”⁶⁸ Such a “modeling exercise” would be unnecessary if Verizon’s prices really had dropped—prices could simply be mapped on a product-by-product basis, as done by WilTel. If mapped that way, they would, however, show that prices for typical special access products have not decreased, only that customers are purchasing transport capacity in larger increments that have lower unit prices (i.e., a single DS1 is priced higher than 1/28 of a DS3).⁶⁹

As AT&T explained in the Triennial Review Remand proceeding, “special access services are not priced or sold in terms of ‘average revenue per VGE,’ but instead [are] denominated in terms of multiple pricing dimensions ... including, among other things, bandwidth (capacity) and distance.”⁷⁰ If Verizon’s claims that its special access prices have dropped were true, it could have shown that through a comparison of actual tariff prices rather than by means of the indirect and inaccurate device of average revenue per VGE.

It is natural for unit prices to decrease when customers shift their demand to larger units. For example, as Dr. Selwyn observes, while an OC-12 facility is equivalent to 336 DS-1s, it is

⁶⁶ Letter from David L. Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, RM-10593, attachment, Reply Declaration of M. Joseph Stith (dated Oct. 19, 2004) (“Stith Dec.”), at ¶ 17 (filed in RM-10593 Dec. 7, 2004).

⁶⁷ SBC Comments, Casto Declaration n.49. SBC asserts that this is due to the X-factor reductions to price cap rates that are mandated by the Commission’s rules and which do not apply in MSAs with pricing flexibility.

⁶⁸ Verizon Comments, Declaration of Dr. William Taylor (“Taylor Dec.”), at ¶ 16.

⁶⁹ Letter from David L. Lawson, Counsel for AT&T, to Marlene H. Dortch, Secretary, RM-10593, attachment, attaching, *inter alia*, Declaration of Lee Selwyn (dated Nov. 8, 2004) (“Selwyn Dec.”), at 8.

⁷⁰ *Id.*, at 9.

typically priced at only about 40 times the price of a single DS-1. “Thus, when purchased as part of an OC-12, the price of a single VGE channel is only 12% of the per channel price when purchased as part of a DS-1.”⁷¹ As Dr. Selwyn further points out, because, in recent years, “the demand for very high capacity OCn services has been growing at a much faster rate than the demand for individual DS-1s or DS-3s . . . even if prices of specific services had remained unchanged, the average ‘revenue per VGE channel’ would fall, because successively larger percentages of voice-grade equivalent channels are being purchased as part of very high capacity OCn services.”⁷²

Dr. Selwyn finds further fault with the RBOCs’ pricing studies in that “Verizon, BellSouth and SBC have all commingled price movements that were *required* under the Commission’s price cap rules with RBOC-initiated price changes made following the onset of pricing flexibility.”⁷³ Dr. Selwyn shows that special access revenues charged by the RBOCs were roughly 18.35% higher than they would have been if the Commission’s GDI-PI 6.5% annual price cap adjustment had been in effect for all special access services and for the periods 1996 – 2003.⁷⁴ Dr. Selwyn further points that the RBOCs’ studies do not consider the extent to which average prices have been reduced by “contracts that impose substantial volume and term commitments, coupled with large financial penalties, in exchange for ‘discounts’ off the prevailing month-to-month pricing.”⁷⁵ These onerous conditions in effect constitute an

⁷¹ Selwyn WilTel Reply Dec. at ¶ 40.

⁷² *Id.*

⁷³ *Id.*, at ¶ 35.

⁷⁴ *Id.*, at ¶ 36.

⁷⁵ *Id.*, at ¶ 39.

additional “price” for the purchase of special access, a price that the RBOC studies fail to consider.⁷⁶

Consistent with WiTel’s conclusions, discussed above, Sprint notes that rates are significantly higher in MSAs with pricing flexibility than in price cap areas.⁷⁷ According to Global Crossing, DS1 channel terminations are 22 to 47 percent higher in Qwest pricing flexibility areas and DS1 mileage rates are 13 to 71 percent higher in BellSouth pricing flexibility areas.⁷⁸ The Phoenix Center and the *Ad Hoc Users Committee* also conclude that the ILECs increase their special access rates where they have pricing flexibility.⁷⁹ Finally, the Declaration of Joseph Stith showed that for 10-mile and 0-mile circuits the ILECs’ tariffed month-to-month and Optional Pricing Plan (“OPP”) rates for DS1 and DS3 subject to pricing flexibility are generally greater than corresponding price cap rates.⁸⁰ When evaluating the differences between 2001 and 2004 month-to-month rates, Mr. Stith consistently found that 2004 rates are equal or greater to the 2001 rates.⁸¹ The results are similar for the ILECs’ OPPs⁸² and zero-mile DS-1 circuit.⁸³

⁷⁶ *Id.*, at ¶¶ 42-43.

⁷⁷ Sprint Comments, at 5. Sprint estimates that its cost for special access in 2004 was \$103 million higher than it would have been under a price cap regime.

⁷⁸ CompTel/ALTS Comments, at 7.

⁷⁹ Set it and Forget it? Market Power and the Consequences of Premature Deregulation in the Telecommunications Markets, at Table 1; *Ad Hoc Users Cmte. Cmts.*, at 21, Attachment C.

⁸⁰ Stith Dec., at ¶ 19, Attachment 1 at 1, and Attachment 2 at 1.

⁸¹ Qwest’s month-to-month pricing flexibility rates for a ten mile DS1 and DS3 are 25 and 56 percent higher, respectively, on average than in 2001 under price cap rates. Reply Declaration of M. Joseph Stith (dated Oct. 19, 2004) (filed in RM-10593 Dec. 7, 2004), ¶ 19 (attached to Ad Hoc Users Comments) (“Stith Rep. Dec.”). Verizon-South’s, SBC’s, Verizon-North’s, and BellSouth’s are 15, 13, 10, and 8 percent higher, respectively. *Id.*

⁸² Qwest raised its DS1 and DS3 OPPs by 13% and 42%, respectively, and Verizon-North increased its DS1 OPPs by 18%. Stith Rep. Dec., at ¶ 17. Although BellSouth and SBC’s rates are the same as in 2001, as discussed previously this is effectively the same as a price increase given the ILECs’ reduced costs. *Id.*, at ¶ 18.

⁸³ *Id.*

SBC argues that such comparisons are arbitrary because the regulated rates are set under price caps determined initially under rate-of-return regulation and various X factors and because the rates in price cap areas might be below what would prevail in a “free” market. SBC misses the point. When the Commission instituted price caps, it sought to emulate the efficiency-maximizing rates that result from a competitive market by taking the base rates (set under rate of return) and applying an X factor to reduce the rates based on ILEC productivity. It is the existence of incremental cost-based rates tied to least-cost production methods, and the desire for profit impelling innovation and further cost and price decreases that yield the efficiency and social welfare maximizing results that policy-makers seek.

Given production-cost decreases and economies of scale combined with increasing demand, as evidenced by pricing changes in other sectors of the telecommunications market, social welfare maximizing prices should be substantially lower than they were in 1999, and if competition in the “free market” were to achieve welfare maximizing prices, such prices would certainly be lower than those controlled by the conservative “X-factor” changes made since 1999. Importantly, no ILEC has brought forth evidence that they are not recovering their costs in areas where price cap regulation is in place.

If SBC’s contention is that “free market” prices would have been higher than price cap rates, and price cap rates already fully recover costs in areas where unit costs should be higher than in pricing flexibility zones, then SBC’s version of “free market” pricing bears no resemblance to the “competitive market” pricing result that policy-makers seek to obtain. The RBOCs have presented no evidence that their costs have gone up—which in some cases their special access prices have. It is also amazing that the RBOCs claim that “free market” special access rates might in many cases be higher than those that are currently constrained by price

caps, and then—as described below—these same RBOCs offer substantial discounts on the price of those supposedly below-cost services in exchange for restrictive contractual terms that have little to do with reducing the costs of producing special access. Viewed from this perspective, SBC’s argument adds up to another apology for monopoly and super-normal profits.⁸⁴

III. THE ILECS’ EXCLUSIONARY CONTRACT TARIFF PROVISIONS DEMONSTRATES THEIR CONTINUED MARKET POWER

A. The Terms of the ILECs’ Discount Plans Reflect The ILECs’ Market Power

RBOCs argue that rather than examining their prices in a head-to-head comparison with those offered by the CAPs using similar terms and conditions, pricing for special access should be reviewed taking into consideration the substantial discounts available under their tariffed revenue and volume commitment plans. As WilTel Reply Exhibit 1 demonstrates, however, even when comparing ILEC discounted prices to those offered by CAPs, the RBOC commands a substantial premium above the CAP rate. Likewise, it is indisputable that discounted ILEC special access rates are higher than UNE rates. The fact that the combination of special access prices, terms and conditions have not become more equal between the incumbents and entrants is already a signal that impediments to competition exist. Closer examination of the terms and conditions to which special access customers must submit themselves in order to obtain discounted prices further reveals the extraordinary leverage the ILECs’ retain by virtue of their historic monopoly .

The vast majority of special access revenues in a given quarter or year stem not from “new” services turned up in that year but from the embedded base of services that have

⁸⁴ SBC Comments, WC Docket No. 05-25, at 34 (The FCC would need to set a rate of return for special access services higher than 11.25% because “competitive pressures subject the ILEC special access business to much greater risk than before”).

accumulated over the course of many years. Under the FCC's current rules the ILECs have been granted the right to leverage this embedded base in order to ensure that customers continue to purchase their new services from the ILEC regardless of the price differential between the new service offer by the ILEC and a lower priced alternative offered by a CAP.

The ILECs' plans typically contain regional demand commitments, mandated bundling of competitive and non-competitive routes, high penalties and non-recurring costs for termination of service.⁸⁵ These terms and conditions would not be accepted by customers if they had realistic competitive alternatives to the ILECs for new services or could easily shift their embedded based demand to alternative suppliers. The ILEC discount plans however, erect substantial barriers to both of these possibilities. "[T]he structure of ILEC discount plans – under which carriers are offered substantial discounts on their total spend only if they meet conditions such as purchasing from the ILEC 90% or more of the amounts of special access they purchase in the past" limit the ability of WilTel to use competitive providers.⁸⁶ Dr. Selwyn has made the same point: because an ILEC is "the only source of special access services to every customer location throughout the LEC's footprint," the ILEC can use discount pricing plans based on a customer's aggregate purchases throughout the ILEC's territory.⁸⁷

Under one SBC plan, for example, "the customer (an IXC or a CLEC) is required to commit 90% of its total special access demand to SBC, or purchase 90% of its base period demand from SBC," to qualify for the discount or avoid incurring a penalty.⁸⁸ In order to meet the volume requirement, special access customers often must forego purchasing special access

⁸⁵ WilTel Reply Exhibit 8 summarizes some examples of RBOC volume commitment plans.

⁸⁶ Initial Comments of WilTel, at 5, 13-14.

⁸⁷ *Id.*, at 13.

⁸⁸ *Id.*

services from a competitor even if the customer could obtain better terms. Another SBC discount plan requires special access customers to buy special access in each of SBC's five regions, regardless of the customer's needs, to qualify for the discount. Again, this prevents a customer from using a competitor's special access services in a particular market even if the competitor's terms are superior to those of SBC. Nearly all RBOCs have comparable plans. Examples of these plans are summarized in WilTel Reply Exhibit 8.

To deter customers further from using competitors, ILECs impose hefty penalties if a customer fails to meet its demand commitment. These penalties result in "bundling"⁸⁹ or "tying" contracts that force customers to purchase ILEC special access even on competitive routes in order to obtain the discounts they need to compete on the majority of routes that are non-competitive.⁹⁰ The plans also have "take or pay" provisions that impose liability if a customer fails to meet its demand commitment. Customers buy unneeded circuits because it is cheaper than paying the penalties.

The ILECs also commonly impose non-cost based charges and follow grooming policies that inhibit special access customer from moving to competitors. SBC imposes a one-time charge in PacBell territory of \$5,000 to move a circuit to another carrier.⁹¹ Broadwing notes that the ILECs impose termination penalties on a circuit-specific basis such that if a customer moves a circuit to a competitive provider, it must pay a termination penalty for that circuit even if its

⁸⁹ The *NPRM* refers to bundling as "the practice ... of conditioning the pricing of the monopoly portion of a customer's demand on the choices the customer makes for the competitive portion of demand." *NPRM*, at ¶¶ 119-125.

⁹⁰ Initial Comments of WilTel, at 9, 19.

⁹¹ *Id.*, at 15; See Pacific Bell Telephone Company, Tariff F.C.C. No. I, § 6.8.2(H), page 6-216, and § 7.5.9 (D), pages 7-189 and 7-190.

overall spending with the ILEC does not change.⁹² Sprint comments that it is “administratively and financially difficult (in some cases, impossible) to efficiently migrate existing special access facilities” to a competitive provider.⁹³ The ILECs also limit the number of circuits that they will migrate. SBC will migrate only eight special access circuits per night per customer.⁹⁴ Others impose high and non-cost justified charges for coordinated migrations.⁹⁵

In contrast, competitive providers of special access offer shorter contractual terms (as little as 1 year) and typically do not charge a termination penalty for a specific circuit if the customer’s overall spending remains above a certain level.⁹⁶ Thus, the ILECs cannot reasonably claim that their terms and conditions are consistent with market practice, except when compared with other ILECs.

The RBOCs also use their incumbency to force customers to recommit service at the end of existing service terms. RBOCs have justified substantial pricing discounts for term commitments on special access by arguing that extended terms allow the RBOC and extended period to recover the capital that was expended in initially constructing and installing the customer’s special access infrastructure. Under RBOC pricing plans, however, if a customer signs up for a 60 month term, in the 61st month that customer must sign up for a new 60 month term or face much higher monthly prices. From a cost perspective there is nothing to

⁹² Broadwing Comments, at 26.

⁹³ Sprint Comments, at 6.

⁹⁴ Sprint’s experience is similar: “[S]ome RBOCs limit the quantities of circuits that can be migrated per night or by type of service, or assess high non-recurring charges for coordinated service termination.” Sprint Comments, at 6-7.

⁹⁵ Verizon imposes a nonrecurring charge per channel termination of \$380 for so-called “Coordinated Retermination.” Sprint Comments, at 7 (citing to Tariff FCC No. 1, Section 7.5.9(a)(1)). In contrast, the installation charge for other services is only \$1.00 per channel. Sprint Comments, at 7.

⁹⁶ Broadwing Comments, at 26-27.

differentiate the 60th month of an existing service from the 61st month. In fact, in the 61st month, deployment and installation costs have been recouped and the circuit price represents nearly pure profit for the incumbent. Yet, from the customer perspective, the RBOC's market dominance puts it in the position of forcing the customer to recommit to another 60 months (at prices designed to re-recoup the RBOCs investment cost) or face the penalty of higher month-to-month pricing.

This pricing mechanism creates a very small window of opportunity for the carrier purchasing special access to work with its end user customer to move service to an alternate special access provider. It precludes purchasers from using their leverage to obtain better pricing on their embedded base by using the threat of moving all traffic to an alternate carrier. Finally, forcing customers to "re-up" to lengthy terms increases the already substantial differential between special access pricing and special access cost. The incumbent RBOC prices the recommitted special access service as if it were based on new capital investment and installation, when in fact, its costs are almost entirely sunk investment that the customer paid for during the *initial circuit term—a very lucrative business—for the seller*. As a result, RBOCs have moved over the past 5 years to substantially increase the pricing differential between short and long-term circuit terms.

Through their imposition of these conditions, the ILECs use their first-mover advantage and the ubiquity of their networks to structure discount plans that have the effect of locking in substantially all of a customer's special access demand and making it economically infeasible for carriers to use competitors for even a portion of their needs. CompTel/ALTS comments that plans such as SBC's Managed Value Plan ("MVP") have allowed ILECs to "entrench their market power ... effectively lock[ing]-up demand and undermin[ing] the ability of carriers to

reach sufficient scale to become effective competitors.”⁹⁷ The ILECs are able to inhibit the development of competition through their discount structure without losing money, because the baseline prices that they are “discounting” are well above cost.

In addition, RBOC discounts have focused on high capacity services where the intensity of traffic demand would be supportive of CAP entry. Meanwhile, the discount plans on which the ILECs base their defense of access charges provide little relief for customers seeking competitive rates, terms and conditions. WilTel Reply Exhibit 3 shows that the vast majority are geared toward lower prices for higher level services such as OCn and SONET rings. A large number address only interoffice services. Only a few contract tariffs are available for channel terminations (or channel termination/interoffice mileage combinations), and even those are almost all subject to the anti-competitive revenue obligations discussed below. The plans do not provide a reasonable substitution for the special access services required by IXC, and they provide real discounts only for long term commitments based on customer revenues for different services in different service areas. What these discount plans show, therefore, is that the market is not competitive enough to constrain ILEC prices.

These ILEC tactics are unreasonable and discriminatory, and thus illegal under the Telecommunications Act. However, for purposes of this proceeding, they are most relevant because they evidence the lack of effective competition in the special access market. If real

⁹⁷ CompTel/ALTS Comments, at 11, 14-20. SBC’s MVP plan “provides discounts on top of those available under SBC’s base tariff discount plan” in exchange for a carrier’s commitment to maintain 100% of historical spending over a five-year period on a bundle of services including special access. CompTel/ALTS Comments, at 14. See, e.g., Southwestern Bell Telephone Co., Tariff FCC No. 73, § 38 at 3rd Revised Page 38-1 through Original Page 38-25 (“MVP Tariff”). The MVP plan imposes a Minimum Annual Revenue Commitment (“MARC”) for a carrier’s total recurring charge bill for nearly all forms of transport (entrance facilities, high capacity DS1, DS3, and OCn services, and certain other services) that must be met to avoid substantial penalties. CompTel/ALTS Comments, at 15; MVP Tariff, at § 38.3. If the customer fails to meet the MARC then it must “choose between paying the difference between its minimum annual commitment and the actual amount spent (becoming effectively a take-or-pay contract) or terminate the agreement and pay termination liabilities. CompTel/ALTS Comments, at 16.

competition existed, the ILECs could not impose such onerous terms and conditions because customers would move their service to competitors. The fact is that the overwhelming majority of market and routes are not competitive and, therefore, the ILECs are able to leverage their market power and prevent customers from using competitive alternatives.

B. The ILEC Discounts Are Not Cost-Justified

These discounted pricing plans might be acceptable if they were based on demonstrated cost savings. The ILECs have, however, produced no evidence to show that a customer's purchase of large numbers of special access circuits in a variety of locations results in any cost savings to the ILEC, much less the 50% discounts available through some plans. Moreover, there is no reason to conclude that the purchase of multiple DS1 or DS3 circuits on diverse routes throughout an ILEC's territory would result in anything more than *de minimus* cost savings. There are a number of scenarios in which cost savings likely would result – the purchase of additional capacity on the same route or the purchase of multiple circuits to a single building or office park – however, the plans at issue are not structured that way. Rather, they are based simply on the number of circuits purchased throughout the entirety of the ILEC's territory. In a competitive market, any discounts offered by an ILEC would be justified by the cost savings, if any, resulting from the customer's bulk purchases. Here, there is simply no evidence or reason to believe that the purchases generate cost savings to the ILECs. In the absence of such evidence, the existence of these plans, with their substantial discounts unsupported by cost savings, is further evidence of the ILECs' continuing monopoly over special access.

ILECs make much of their contract tariffs, explaining that even if the pricing flexibility base rates are stable or increasing, contract tariffs provide special access customers with steep discounts. These discount plans, however, come replete with numerous strings that tie future purchases to existing demand for existing services on incumbent providers. They mark a

substantial move away from generally available prices and flexible terms that would force the ILEC to compete on price for business on a circuit-by-circuit basis. The fact that virtually all RBOCs have implemented and expanded these discount plans is evidence that they increase profits over their alternatives. In other words overall prices must be higher, and profitability greater under these plans than they would have been otherwise, or the RBOCs would not have implemented and expanded them. Indeed, these plans have proven so successful in limiting entry and price competition that industry participants have referred to such plans as “CAP Killers.”

IV. PRICING AND PROFIT DATA SHOW FUNDAMENTAL MARKET FAILURE

A. WilTel’s Analysis Reveals Fundamental Market Failure In Special Access Pricing

Based on the WilTel analysis discussed above, showing that RBOCs charge higher prices for service terms and conditions that generally match those offered by CAPs, and the fact that RBOCs have not lost substantial market share, one must conclude that one or more of the following are at issue:

1. RBOC and CAP access are not close substitutes.
2. RBOC revenue commitment plans via lower pricing or commitment levels have locked up sufficient demand that services do not migrate away from incumbent providers.
3. CAPs do not offer service in a significant number of locations relative to the whole.

Given these empirical observations, it is clear that the market fails to discipline RBOC prices in a manner consistent with (or even remotely approximating) those of a truly competitive market. Thus, from an economic perspective, the market also fails to deliver service at prices reflective of underlying cost, and output/demand is less than optimal. Because special access is a critical component in offering a wide variety of voice, data, and video services, such a failure is

likely to have the downstream impact of limiting demand for new and innovative services that drive growth in the national economy.

B. ARMIS Data Shows That ILECs Enjoy Monopolistic Profits

The ILECs' extraordinarily high rates of return on special access services, as shown by the ARMIS data, also demonstrate that the ILECs retain market power over special access services. The ILECs argue that the ARMIS data is flawed.⁹⁸ WilTel does not intend to address the ILECs' arguments regarding the ARMIS data fully, but refers the Commission to the Reply Comments filed by the Joint CLECs in this proceeding.⁹⁹ It bears mentioning, however, that the ILECs rely on ARMIS data when it benefits them (such as when it shows that UNE prices are too low), and they have stressed the quality and reliability of that data in such settings.¹⁰⁰ Similarly, the ILECs cannot claim that the purported misallocation of costs to the Common Line category inflates ARMIS-based rates of return when in other proceedings they have stated that special access costs are not being misallocated.¹⁰¹ In any event, even if there are misallocations, it is more likely that costs from other ILEC services are being improperly assigned to special access than the reverse.¹⁰²

⁹⁸ Verizon Comments, at 17; SBC Comments, at 24; BellSouth Comments, at 8; Qwest Comments, at 10.

⁹⁹ See Joint CLECs' Reply Comments, WC Docket 05-25, at Section I.B.

¹⁰⁰ *In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, WC Docket No. 05-25, RM Docket No. 10593, Comments of the Ad Hoc Telecommunications Users Committee, at 29-30 ("Ad Hoc Users Comments").

¹⁰¹ *Ad Hoc Users Comments*, at 30.

¹⁰² ETI has explained that for 2003, the new investment allocated to the special access category for the BOCs was roughly one third of their total interstate net investment and approximately 40% of their combined Common Line and Special Access Investment categories. ETI White Paper, at 33. ETI stated that because there are fewer than 4-million special access loops and associated interoffice transport facilities, compared to more than 158-million Common Line local service loops in the BOCs' operating territories, the investment allocated to special access is disproportionate to the number of special access loops as a percentage of total loops. *Id.* The discrepancy between the number of loops used for special access and the amount of interstate investment assigned to those loops raises suspicions that costs are being overallocated to the special access category. *Id.*

In addition, while the ILECs claim that costs are misallocated, they have ignored the Commission's invitation to adjust the ARMIS data and recalculate the growth rates.¹⁰³ Instead, the ILECs attack the ARMIS data and its uncomfortable conclusions. These actions are highly suspect as the ILECs certainly have the means to undertake the analysis the Commission proposed. Absent any attempt by the ILECs to do so, the Commission should presume that the ARMIS data and rates of return are accurate.

V. THE RBOCS' REQUESTS FOR REGULATORY RELIEF MUST BE REJECTED

A. Further Phase II Relief Is Unwarranted

Based upon its claims that there is extensive competition for special access services and that its prices have not substantially increased, BellSouth requests that the Commission grant Phase II pricing flexibility everywhere and discontinue price regulation for special access after two years.¹⁰⁴ The Commission should reject BellSouth's request and should deny any further regulatory relief to the ILECs. The evidence is clear that ILEC special access prices have, at best, decreased slightly. BellSouth even admits that some of its prices have increased. Moreover, the ILECs continue to impose restrictive contract terms and conditions that further limit competition. Given sharply declining costs, a competitive market would have resulted in substantially lower prices and the elimination of onerous contractual terms. Given that pricing flexibility has not resulted in the competition or cost-based pricing that the Commission anticipated, there is no reason to believe that further deregulation will result in substantially lower prices for special access. Rather, a further reduction in oversight of the ILECs' special

¹⁰³ *NPRM*, ¶ 29.

¹⁰⁴ BellSouth Comments, at 48.

access rates, terms and conditions is likely to lead to further abuses by the ILECs and continued stagnation of prices. Therefore, the Commission should significantly tighten the Phase II pricing flexibility rules as described in WilTel's Initial Comments and these Reply Comments.¹⁰⁵

B. The Commission Should Not Eliminate Service Categories And Sub-Categories in the Special Access Basket

SBC proposes that the Commission restructure the special access basket to contain two service categories: "DS3 and below Channel Terminations to End Users" and "All Other." SBC argues that dividing the remaining services into two baskets correctly groups the price cap services that face the most similar competitive conditions.¹⁰⁶ SBC's proposal would eliminate separate categories for Voice Grade, WATS, Metallic services, and Audio & Video service in favor of its proposed "All Other" service category and would remove OCn services from price-cap baskets entirely.¹⁰⁷ Verizon goes even further and recommends that the Commission eliminate all service categories and sub-categories within the special access basket.¹⁰⁸

The Commission should reject these proposals. Instead, it should adopt WilTel's proposal to establish separate baskets for DS1 and DS3 special access services and to create four categories within these baskets: (1) special access channel terminations between the LEC end office and the customer premises (loops); (2) channel mileage between LEC central offices (transport); (3) special access channel terminations between the IXC POP and the LEC serving

¹⁰⁵ Moreover, contrary to the implications of the ILECs, there is nothing preventing them from reducing prices of their own accord.

¹⁰⁶ SBC Comments, at 62.

¹⁰⁷ SBC Comments, at 63.

¹⁰⁸ Verizon Comments, at 37.

wire center (entrance facilities) and (4) any other special access product.¹⁰⁹ High-capacity services above the DS-3 level should be placed in a separate basket that does not include categories insofar as the Commission's determination is correct that the market for these services is competitive.¹¹⁰ Other retail services should have a separate basket as well.

The Commission also should establish a separate basket for mass market broadband and DSL services. These services compete directly with cable offerings, existing in a duopoly that, for now, is price competitive, unlike traditional special access services.¹¹¹ If the ILECs want to compete for these mass market customers by lowering these prices, they should not be permitted to subsidize these services by further inflating special access charges. To prevent any threat of such anticompetitive conduct, the costs and revenues associated with mass market broadband and DSL services should be assigned to a separate basket.

C. Phase II Pricing Flexibility for Special Access Should be Applied at the Wire Center Level Based on the Existence of Multiple Fiber-Based Collocators

As the Commission recognized in its 1998 *Pricing Flexibility Order*, competition does not occur uniformly in an MSA. Rather, there may be no competitive alternatives for special access in some wire centers in an MSA that is nevertheless eligible for Phase II pricing flexibility. Nothing in the ILECs' comments in this proceeding alters those conclusions. Accordingly, the Commission must discard its MSA approach to grants of pricing flexibility in favor of a wire center analysis for Phase II pricing relief for interoffice transport.

¹⁰⁹ The 5 percent upper pricing band that currently applies to special access services and categories should also apply to the baskets and categories being proposed herein "to protect ratepayers from substantial changes in services rates." See *LEC Price Cap Order* paras. 223-24; 47 C.F.R. § 61.47(e).

¹¹⁰ See, e.g., *Triennial Review Order*, ¶¶ 315 & 389.

¹¹¹ *NPRM*, ¶ 52.

It is also clear that the triggers adopted in the 1998 *Pricing Flexibility Order* do not accurately measure where competition in an MSA is sufficient to constrain BOC pricing and produce forward-looking pricing. As discussed above, prices have not declined significantly where Phase II pricing flexibility has been granted.¹¹² This fact alone invalidates the current triggers and MSA-wide approach for granting pricing flexibility.

The Commission has already developed triggers that identify where competitive transport alternatives may exist on a route-by-route basis. In the *Triennial Review Remand Order*, the Commission adopted a wire center approach for measuring impairment for access to interoffice transport as an unbundled network element.¹¹³ Under that approach, impairment for interoffice transport is determined by reference to the number of access lines or fiber-based collocators in the wire centers on both ends of the route.¹¹⁴ While this approach is not entirely accurate for identifying the presence of effective competition, it is an improvement over the current MSA approach because transport competition would be identified on a basis closer to the way that it actually occurs, *i.e.* on a route-by-route basis. Accordingly, the Commission should establish a wire center approach for determining eligibility for pricing flexibility for interoffice transport that requires multiple (three or more) fiber-based collocators that are independent of the ILEC, that have actually deployed competitive facilities, and that are offering them to competitors. Only in this way will actual, rather than hypothetical, competition exist for special access services.

D. Pricing Flexibility Triggers Should Not be Modified to Measure Non-

¹¹² Joint CLECs' Comments, at 10-13.

¹¹³ *Triennial Review Remand Order*, ¶111.

¹¹⁴ Dr. Selwyn's Reply Declaration includes a discussion of the standard adopted by the Commission in the *Triennial Review Remand Order*. Selwyn WilTel Reply Dec., at ¶¶ 28-30.

Collocated CLEC Networks or Intermodal Competition

The Commission should reject SBC's and Verizon's requests to modify triggers for pricing flexibility to take into account non-collocated CLEC networks and intermodal competition.¹¹⁵ These carriers have been arguing in the *Triennial Review Remand Proceeding* that business line density and fiber-based collocation are satisfactory proxies for revenue opportunities that will adequately predict the actuality and potential for competition.¹¹⁶ They go so far as to contend that business line density and fiber-based collocation are sufficiently acceptable proxies for competition to the extent that it does not matter what methodology the Commission uses in counting business lines, as long as it is consistently developed and applied.¹¹⁷ This advocacy negates their claim in this proceeding that fiber-based collocation triggers are inadequate to predict competition. Accordingly, the Commission should reject requests to modify pricing flexibility triggers in the ways requested by the ILECs.

E. RBOC Requests for X-Factor Should Be Rejected

In its Initial Comments, WilTel recommended that the Commission should make a productivity-based X-Factor a key feature of new permanent price cap rules. Because the ILECs threaten to reduce their investment in network efficiencies in the face of new price caps, it is even more important that the Commission reinstitute an X-factor to ensure that ILECs capitalize on the technological advancements of their suppliers to improve their productivity.

The ILECs argue against a special access specific X-factor because “[s]pecial access services are not produced on a stand-alone basis; they use the same network facilities and

¹¹⁵ Verizon Comments at 35; SBC Comments, Casto Declaration at 17.

¹¹⁶ Verizon Opposition to Petition for Reconsideration, WC 04-313, at 35-36; SBC Opposition to Petition for Reconsideration, WC 04-313, at 19-20.

¹¹⁷ *Id.*

managerial functions as all of the other outputs of a telecommunications firm.”¹¹⁸ This argument actually militates in favor of a specific X-factor. As the *Ad Hoc Committee* showed,¹¹⁹ high special access returns are subsidizing the costs of other competitive or quasi-competitive services. Rather than using their excess earnings from special access to undermine competition, the ILECs should be sharing these benefits with consumers. The X-factor would do that.

Similarly, SBC argues that the proposed 5.3% X-factor is incorrect because it was developed 10 years ago and covered all price cap services, not just special access. If anything, this suggests that 5.3% is too low, since recent ILEC technology enhancements focus on last mile facilities (hybrid loops, FTTC, FTTH), which would have a greater effect on special access service efficiency than it would for other price cap services like switched access or transport.

To address these shortcomings, the Commission should re-impose a productivity-based X-factor in the price cap formula to ensure that rates continue to decline relative to GNP-PI.¹²⁰ The Commission should apply the X-factor prospectively and retroactively to 2004, when the Commission eliminated the X-factor and froze the PCI.

VI. CONCLUSION

The Commission’s 1999 decision to grant pricing flexibility for special access service was granted based on the widely-accepted premise that competition would continue to grow and that the ILECs would be forced to move to cost-based pricing. Quite simply, things did not work out as expected. For a myriad of reasons, the rosy predictions did not come true and special access remains a *de facto* ILEC monopoly. Despite rapid cost decreases, special access prices

¹¹⁸ Verizon Comments, at 42. *See also* Qwest Comments, at 9.

¹¹⁹ ETI White Paper, at 33.

¹²⁰ *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, at ¶ 75 (1990) (subsequent history omitted) (“*LEC Price Cap Order*”).

have declined slightly, if at all, and the ILECs have an almost unfettered ability to impose anticompetitive terms and conditions that throttle competition in the special access market.

It is too late to expect substantial competition to develop in the special access market. The impending elimination of AT&T and MCI as competitors to the ILECs will remove the only meaningful national competitive providers of special access, and the substantial practical barriers to entering the special access market make it unlikely that a competitor will emerge in the near future. Further, the likely reduction in UNE offerings that will result from the Commission's recent orders will make competitors even more dependent on special access.

The Commission must therefore address the reality of the special access market as it is, acknowledge the market power of the ILECs, and ensure the existence of competition by regulating the ILECs as dominant providers of special access. Given the Supreme Court's determination last year that antitrust courts should stay their hands in deference to regulators with respect to competition issues in the telecommunications industry, noting that "regulation significantly diminishes the likelihood of major antitrust harm,"¹²¹ it is especially critical that the FCC take effective steps to prevent anticompetitive practices by the ILECs.

Based on the evidence WilTel documents herein, WilTel is driven to the clear conclusion that the Commission must take action to ensure that the ILECs can no longer abuse their market

¹²¹ *Verizon Comm'ns v. Trinko*, 540 U.S. 398, 412 (2004), quoting *Concord v. Boston Edison Co.*, 915 F.2d 17, 25 (1st Cir. 1990). The Commission should be especially vigilant to ensure that the ILECs do not persuade the FCC and the courts to engage in an "Alphonse and Gaston" routine in which each defers to the other. Before Verizon succeeded in persuading the Supreme Court in *Trinko* that it should not allow the application of the antitrust laws to its allegedly anticompetitive conduct because of the existence of a regulatory remedy, it successfully argued just the opposite to the Commission, arguing that the Commission should not apply more stringent regulatory safeguards because if Verizon were "to engage in anticompetitive conduct, carriers would of course be able to resort to private remedies under . . . the treble-damages remedy of the federal antitrust laws." *In Re Application of GTE Corp. and Bell Atlantic Corp. for Consent to Transfer Control of Domestic and International Sections 214 and 310 Authorizations and Application to Transfer Control of a Submarine Cable Landing License*, Memorandum Opinion and Order, 15 FCC Rcd 14032 (2000), at ¶ 24.

power in the special access market and to ensure that, where feasible, competition does replace regulation and a means of achieving efficiency-maximizing prices and service quality. There are three principal steps to the reform required.

1. In areas where the FCC has not granted pricing flexibility, price caps need to be reinitialized to reflect forward-looking incremental cost and an aggressive X-factor is needed to provide incentive for further productivity and cost improvements by the ILECs.
2. In areas where the FCC has granted pricing flexibility ILECs should be free to deaverage their prices by lowering them, but the price cap rate should act as a ceiling on special access prices even where flexibility is granted. WilTel would support deaveraging in smaller geographic areas so long as the same prices for standard terms are available to all special access customers.
3. Price competition for special access should be reintroduced. For CAP entry to exercise a force for obtaining efficient pricing and improved service quality then commitment-based, growth-based, "CAP Killer" tariffs and contract tariffs must be eliminated. While ILECs facing rivalry should be allowed to compete in price and service quality for new and existing services, the use of commitment-based, growth-based, and volume-based discounts forestalls any real competition and discourages entry because it eliminates the ability for customers to select a service provider based on current price and service-level criteria. Simplifying pricing to a form in which ILECs simply compete for the next deal based solely on the price and service for that particular deal will create an environment where the best provider for that particular deal will win. Today, despite market entry, real competition is stillborn. Even where the entrant offers a superior combination of price and quality, this is overshadowed by the leverage that the ILEC possesses by virtue of its commitment plans

For the reasons set forth above, the Commission should reform its rules governing special access pricing.

Respectfully submitted,

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EXHIBIT 1

Comparison of DS1 Monthly Charges for a 12 Month Period - Oklahoma City Market
Includes 5 Circuit Miles

